No. 16109

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

MARGARET LILLIAN FERGUSON, NEWTON IVAN SHERRY and LOIS SHERRY,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Brief for Appellants, Margaret Lillian Ferguson, Newton Ivan Sherry and Lois Sherry.

CHARLES H. CARR,
650 Subway Terminal Building,
417 South Hill Street,
Los Angeles 13, California,
Attorney for Appellants.

Parker & Son, Inc., Law Printers, Los Angeles. Phone MA. 6-9171.

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This is an appeal from decisions of the Tax Court of the United States in the cases of Margaret Lillian Ferguson v. Commissioner of Internal Revenue, and Newton Ivan Sherry and Lois Sherry v. Commissioner of Internal Revenue, entered on May 19, 1958 [R. 61, 62*], following a trial before the Tax Court of petitions for redetermination of deficiencies set forth by the Commissioner of Internal Revenue in Notices of Deficiency dated October 28, 1954 [R. 5-17, 26-36].

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*References to the printed Transcript of Record are referred to herein as "R." followed by the page numbers to which reference is made.

Jurisdictional Statement.

(1) The jurisdiction and venue of this Court to review the decisions in question is provided in Title 26, *United States Code,* Section 7482.

(2) The pleadings necessary to show the existence of jurisdiction are:

(a) Petition of Margaret Lillian Ferguson [R. 5-17]; Answer of Commissioner [R. 17-23]; Reply of Margaret Lillian Ferguson [R. 24-25];

(b) Petition of Newton Ivan Sherry and Lois Sherry [R. 26-36]; Answer of Commissioner [R. 37-43]; Reply of Newton Ivan Sherry and Lois Sherry [R. 43-45];

(c) Memorandum Findings of Fact and Opinion of the Tax Court of the United States [R. 49-61];

(d) Decision of the Tax Court of the United States in the case of Margaret Lillian Ferguson [R. 61];

(e) Decision of the Tax Court of the United States in the case of Newton Ivan Sherry and Lois Sherry [R. 62];

(f) Petition for Review [R. 63-65];

(g) Statement of Points on which Appellants Intend to Rely [R. 198-199].

Statutes Involved.

Internal Revenue Code, 1939, as amended, Title 26, *United States Code,* Section 181:

> "Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity."

Internal Revenue Code, 1939, as amended, Title 26, *United States Code,* Section 182:

> "In computing the net income of each partner, he shall include, whether or not distribution is made to him—

"(a) As part of his gains and losses from sales or exchanges of capital assets held for not more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for not more than 6 months.

"(b) As part of his gains and losses from sales or exchanges of capital assets held for more than 6 months, his distributive share of the gains and losses of the partnership from sales or exchanges of capital assets held for more than 6 months.

"(c) His distributive share of the ordinary net income or the ordinary net loss of the partnership, computed as provided in section 183(b)."

Internal Revenue Code, 1939, as amended, Title 26, *United States Code,* Section 183(a):

"The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual . . ."

Internal Revenue Code, 1939, as amended, Title 26, *United States Code,* Section 3797(2):

"The term 'partnership' includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term 'partner' includes a member in such a syndicate, group, pool, joint venture, or organization . . ."

Question Presented.

During the fiscal years ending June 30, 1945, and June 30, 1946, was there a *bona fide* and valid partnership, for the purposes of taxation, among appellants, their father, and their stepmother?

Specification of Errors Relied Upon.

(1) The Findings of Fact, Conclusions of Law, and Decisions of the Tax Court of the United States are not supported by the evidence.

(2) The Decisions of the Tax Court of the United States are contrary to law.

Summary of the Evidence

Petitions for redetermination of deficiencies and penalties were filed with the Tax Court of the United States by Margaret Lillian Ferguson and by Newton Ivan Sherry and his wife, with respect to income taxes of Margaret Lillian Ferguson for the calendar years 1944, 1945, and 1946, and with respect to income taxes of Newton Ivan Sherry and Lois Sherry, his wife, for the calendar years 1945 and 1946.

It was stipulated by the Commissioner that the deficiencies alleged were not due to fraud, and that the penalties for fraud were not applicable [R. 47]. It was also stipulated that the statute of limitations had expired for the year 1944 [R. 47], thus leaving in issue the years 1945 and 1946 in each case. It was also stipulated as follows:

> "The only issue with respect to income is whether or not these petitioners are taxable on a distributable share of the income of Sherry Enterprises, since petitioners Margaret Lillian Ferguson and Newton Ivan Sherry contend that they were not partners in Sherry Enterprises. Petitioners do not contest respondent's determination that the net worth statements set forth in the notices of deficiency reflect the income of Sherry Enterprises for the fiscal years 1945 and 1946, because they state they have no knowledge or information regarding the same" [R. 47].

Since there was but a single issue, involving identical years, the two petitions were consolidated for trial [R. 109].

Newton Ivan Sherry (hereinafter referred to as Newton) and Margaret Lillian Ferguson (hereinafter referred to as Margaret) are the son and daughter of Nathan Sherry, deceased [R. 47]. Lois Sherry was the wife of Newton Sherry during the years in question [R. 47], but is now separated from him [R. 87], and her only connection with the issue is that she filed joint returns with Newton [R. 50]. Lucille Lawler Sherry was the wife of Nathan Sherry and the stepmother of Newton and Margaret [R. 47]. The mother of Newton and Margaret died in 1937 [R. 151].

Throughout the period relevant to this proceeding Nathan Sherry possessed a power of attorney to act in behalf of Newton and Margaret [R. 53].

Commencing in December, 1940, Nathan Sherry and one Paul Kalmanovitz became associated as partners in business, becoming known as the S & P Company in 1941 or 1942 [R. 157]. The partnership operated various bars and nightclubs in Los Angeles, San Francisco, Oakland, and Pasadena [R. 158]. Kalmanovitz and Nathan Sherry were the principal partners, except that for a while they had additional partners in some of the individual enterprises [R. 158]. In 1947, following a disagreement, the partnership was terminated [R. 160-161] and Kalmanovitz took all of the partnership assets with the exception of seven lots on La Cienega and the Clover Club building and real property, which were distributed to Nathan Sherry as his share of the assets [R. 161].

In January, 1940, Newton (then approximately twenty years of age) joined the Marine Corps, in which service

he remained until his discharge in May, 1945 [R. 90]. Margaret enlisted in the Waves, a branch of the Navy, in February, 1943, and remained in the service until November, 1945 [R. 110]. She was twenty years of age at that time [R. 151].

In 1943, Nathan Sherry discussed with his accountant, Herndon Hughes, and an attorney, George Williams, now deceased, the formation of a family partnership [R. 68]. Nathan Sherry and his second wife were apparently not getting along very well together during this period [R. 154]. Nathan Sherry discussed with his accountant and attorney his family problems at some length and his desire to protect his children; and the idea of a family partnership developed at this conference [R. 77]. Mr. Williams thereafter drafted the partnership agreement [R. 68; Ex. G], and Mr. Hughes drafted gift tax returns [R. 69; Exs. I and J].

The purpose of the partnership, as discussed by Nathan Sherry with his accountant and his attorney, was an *effort to divide his estate, rather than his income,* and to protect his children by so doing [R. 77-78]. The tax advantage was discussed [R. 77]. Only a part of his property interests was included in the agreement [R. 79].

Prior to the death of their mother in 1937, Margaret and Newton were informed by her that she was leaving $20,000.00 to them [R. 105]. Nathan Sherry later told Margaret that he was holding that money for her and for Newton [R. 128-129]. According to the Articles of Copartnership [Ex. G], and the gift tax returns [Exs. I and J], the interests in property purportedly conveyed to Newton and Margaret as their portion of the partnership came entirely from the community property of Nathan Sherry

and his wife, Lucille Lawler Sherry, stepmother of Newton and Margaret, and were acquired subsequent to their marriage on April 1, 1938.

At the time the partnership agreement and gift tax returns were drafted, both Newton and Margaret were away from home in the armed services [R. 90, 110]. No discussions were had with either of them before or during the drafting of these instruments [R. 69-70].

The partnership agreement was signed by Newton while serving as a sergeant in the Marine Corps on Guadalcanal [R. 86; Ex. G]. His father sent him the document with the request to sign it and mail it back, which he did [R. 87]. Newton did not read the document when he signed it [R. 86-87]. Newton considered his father a very aggressive man, and always did what he told him to do, whether right or wrong [R. 107-108]. The donee's return with respect to the purported gift [Ex. I] was not presented to Newton, but was signed by his father as attorney-in-fact.

The partnership agreement [Ex. G] was signed by Margaret while she was serving in the Waves at Dayton, Ohio [R. 111]. It was signed on the instructions of her father [R. 110-111]. She was never consulted by her father, her stepmother, or her brother with respect to the agreement [R. 111]. She signed the gift tax returns [Exs. I and J], but does not recall the fact, or of having read them [R. 114]. She had no discussion with anyone relative to the formation of a partnership [R. 113].

When Newton was returned to this country from Guadalcanal, he was first sent to a hospital in Philadelphia, where he learned lipreading to correct deafness before his discharge [R. 86-87]. After his discharge in May, 1945,

he attended college until November, 1945, and went to work as manager of a drive-in and bar owned by S & P Company at $110.00 per week [R. 91-92]; then he went back to house painting for a while, and also worked for Le Fleur de California, a perfume business owned by his father [R. 97-98]. At the time of the trial, his employment was that of a house painter for wages [R. 85]. He never conducted any business for Sherry Enterprises partnership [R. 89], nor supplied any of the funds used to pay taxes on income reported from Sherry Enterprises [R. 89]. He had nothing to do with the preparation of tax returns for 1945 and 1946 [R. 89], or with the books, records, or returns of Sherry Enterprises [R. 90-91]. The returns were signed by him at the request of his father [R. 96]. The returns were prepared by an accountant at the request of Nathan Sherry, without consultation with Newton, and the checks in payment of the taxes shown thereon were issued by Nathan Sherry [R. 167-168].

The partnership returns for Sherry Enterprises for the fiscal years beginning July 1, 1944, and ending June 30, 1945, and beginning July 1, 1945, and ending June 30, 1946, respectively, were signed by Nathan Sherry and filed with the Collector of Internal Revenue [Exs. E and F]. Neither Margaret nor Newton examined, signed, or had anything to do with the preparation of these returns [R. 71, 74]. They were prepared and filed under the direction of Nathan Sherry [R. 70].

In 1946, Newton purchased a home for $8,599.00, the money being furnished to him by his father; the house was sold later in the same year and the money returned to his father [R. 98]. Newton did not consider the house as belonging to himself, but as an asset of Sherry Enterprises [R. 100].

Newton Sherry did not at any time receive any funds from the Sherry Enterprises partnership [R. 89].

Margaret Ferguson was discharged from the Navy in November, 1945 [R. 110], and then attended the University of Southern California from January 2, 1946, to June, 1946 [R. 122-124]. Commencing in September or October, she was employed by Sherry-Dunn, a perfume business owned by her father, until she was married the following March [R. 129-130]. She answered the telephone, took messages, and performed similar tasks [R. 130]. She understood that Sherry-Dunn was a part of Sherry Enterprises [R. 130-131]. During this period, she lived at home with her father, and had a joint bank account with him, on which she drew for household expenses [R. 118]. She also ran errands for her father, occasionally making deposits and cashing checks [R. 117]. She did nothing to help manage the partnership [R. 117], was not consulted as to policy [R. 118], and was not even given a chance to voice opinions [R. 119]. She never received any of the income from Sherry Enterprises [R. 122] or supplied any of the money to pay taxes on the income from Sherry Enterprises reported on her returns [R. 122]. The accountants who prepared the individual returns for Newton and Margaret did so at the request of Nathan Sherry and without consultation with either Newton or Margaret [R. 69-73, 165-167] and the checks to pay the taxes were issued by Nathan Sherry.

When Margaret returned from the service, she received a check for $500.00 from her grandmother's estate, which she turned over to her father, who said he would put it in the business [R. 119-120], but did not say which business [R. 120].

In 1945 and 1946, some lots on Santa Monica Boulevard and a building were placed in the name of Margaret, or in the name of Marton Holding Company (the record is not clear as to which). Marton Holding Company was a corporation set up by Nathan Sherry with the explanation that he desired to protect his children [R. 130-131]. Margaret did not consider the properties as belonging to her, and believed that they were a part of Sherry Enterprises [R. 131]. The final disposition of this property does not appear in the record.

In 1947, Margaret was given stock in Marguery Corporation, which operated Lucy's Restaurant [R. 134-135]. At the time of the trial, she was manager of this restaurant [R. 135]. She considered this to be her property when received [R. 136]. Her father used funds of Sherry Enterprises to purchase the stock [R. 136]. The stock is worthless [R. 139].

At the time of the trial, Margaret was the owner of an apartment house at 647 North Irving Boulevard, Los Angeles, which was given to her by her father [R. 136-137]. The property is valued at $14,000.00 [R. 138-139]. She does not know where the funds came from to purchase it [R. 137].

At the time of the trial, Margaret was the record owner of a triplex at 1810 Courtney Avenue, which she acquired from Sherry Enterprises in 1950 [R. 138]. Its approximate value is $35,000.00, and Margaret has made and is making the mortgage payments on the property [R. 138].

Newton and his wife signed a "Waiver of Restrictions" on the Assessment and Collection of Deficiency in Tax dated July 19, 1948, for the year 1945, agreeing to additional tax in the amount of $1,114.42 [Ex. K]. Newton

testified that when he signed it, he did not understand it, but signed at his father's request [R. 101].

Margaret signed a "Waiver of Restrictions on the Assessment and Collection of Deficiency in Tax" dated July 19, 1948, for the year 1945, agreeing to additional tax in the amount of $1,109.75 [Ex. L]. Margaret testified that she had no recollection of signing the document, but that "all of these things were presented to me to sign, and I never knew. I took them to be correct and I signed them" [R. 140].

On November 2, 1949, in the course of the investigation of Nathan Sherry by the Intelligence Unit, Newton testified that on that date he was a partner in Sherry Enterprises [R. 103-104]. Before the Tax Court, Newton testified that he had given such testimony to the Special Agent "because it was wrote up as a partnership" [R. 104]. ". . . Well, considering yourself and participating and receiving funds out of it that you can put in the bank and keep, it's a different thing" [R. 103].

On May 15, 1950, in the course of the same investigation, Margaret testified under oath that she was at that date a partner in Sherry Enterprises [Ex. M]. She based her statement that she felt there was a partnership upon the fact that her father told her there was a partnership [R. 143]. Nathan Sherry was indicted for criminal tax evasion and was tried on the charges in August of 1952 [R. 145]. Up to the time of the trial of her father, Margaret had never seen a copy of the 1945 or 1946 partnership returns [R. 112].

Up until the time of the dissolution of S & P Company in 1947, Paul Kalmanovitz never heard of Sherry Enterprises [R. 157], nor was he ever notified that Sherry Enterprises owned any part of S & P Company [R. 158].

Neither Newton nor Margaret ever took any part in the management of S & P, nor did they take part in the negotiations relative to dissolution [R. 158-161].

One of the former S & P properties taken by Nathan Sherry upon dissolution of that company was the Clover Club and its underlying real property [R. 161]. This property was put in trust by Nathan Sherry for the benefit of Margaret and Newton [R. 179-180]. The Clover Club burned down [R. 180], the property was sold, and Nathan received all of the proceeds [R. 180]. The trust vanished, with the beneficiaries receiving nothing [R. 180-181].

Newton and Margaret never asked to examine, or examined, any books or records of Sherry Enterprises or of S & P [R. 90-91, 122, 158]. Neither Newton nor Margaret had anything to do with the preparation either of the partnership returns involved [R. 71] or of their own personal returns [R. 71-74, 166-168].

Partnership books were first compiled in 1947, after the investigation by the special agent of the Treasury Department had commenced [R. 176].

On the basis of the above evidence, the Tax Court held that Newton and Margaret were partners in Sherry Enterprises for the fiscal years ended June 30, 1945, and June 30, 1946, respectively [R. 58], and accordingly rendered decisions against them [R. 61-62].

Argument.

We are concerned here with the sole question of whether or not there existed among appellants, their father, and their stepmother, during the fiscal years ended June 30, 1945, and June 30, 1946, a *bona fide* and valid partnership for the purposes of taxation.

The standard by which an alleged "family partnership" is to be measured was laid down by the Supreme Court in the now famous case of *Commissioner v. Culbertson* (1949), 337 U. S. 733, 93 L. Ed. 1659. At page 742 of that case the Court stated:

> "The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the Tower case, but whether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise."

Applying the language of the *Culbertson* case, therefore, for the purpose of determining the ultimate question of whether "the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise," we find the following evidence applicable:

(a)". . . considering . . . the agreement":

The agreement was drawn entirely at the dictation of the father (Nathan), without consultation with either of the appellants; was signed by them on his orders, when each was away from home in the armed services during time of war; and appellants were later informed that it was only a method of protecting them in the event of their father's death.

(b) ". . . the conduct of the parties in execution of its provisions . . .":

The father continued to operate the assets for his own benefit, retaining all of the income for his own purposes and benefit, and without accounting to appellants. Appellants never at any time took part in the management of the business or businesses involved, never received accounts or statements, and were not even shown partnership returns or consulted with respect to their individual returns. The managing partner of S & P Company, the interest in which was the principal asset of the alleged partnership, was never informed that fifty per cent of S & P had been assigned to the purported partnership. Appellants were not consulted with reference to the disposition of the assets of the alleged partnership and their apparent disappearance. No books or records were created for the alleged partnership until after the years in question.

(c) " . . . their (the parties') statements . . .":

The Government placed strong reliance upon statements purportedly against interest made by Newton in 1949, and by Margaret in 1950, that they were at that time partners in Sherry Enterprises. Both, however, were relying upon the statements of their father and the fact that the agreement had been written up and signed by them; moreover,

as will be pointed out hereinafter, the existence of a partnership in 1949 or 1950 would not necessarily import the existence of the partnership in 1945 and 1946;

(d) ". . . the testimony of disinterested persons . . .":

The testimony of the disinterested witnesses, Herndon Hughes, Paul Kalmanovitz, and James Murray, shows clearly that the appellants were not consulted either before or after the partnership agreement was signed, did not participate in the business, did not receive accounts or statements, did not prepare or participate in the preparation of returns, received no income or profits, and, indeed, were entirely disregarded.

(e) ". . . the relationship of the parties . . .":

Nathan Sherry, the father, was clearly a dominant individual, so far as his children were concerned. Their practice was to sign whatever he put before them, as they trusted him implicitly, and did not question him; indeed, the evidence indicates that the father would have brooked no questioning from his children.

(f) ". . . their (the parties') respective abilities . . .":

The father, Nathan, was apparently a highly successful and aggressive business man, with a background of circulation work for daily newspapers, followed by the operation of bars, night clubs, and restaurants. The appellants had had no business experience of any kind prior to or during the years in question.

(g) ". . . their respective . . . capital contributions."

Aside from the purported gift set forth in the partnership agreement and gift tax return, the appellants made no contributions either of capital or services to the alleged

partnership, either prior to its inception or up to and including the years here in question. The $20,000.00 purportedly originating from their mother and held by Nathan Sherry for the benefit of Newton and Margaret was obviously a myth. No proof was adduced that such fund existed or was contributed to the partnership, nor is there any evidence which would indicate that the money received by Newton and Margaret from their grandmother's estate, in the amount of $500.00 each, ever found its way into the partnership.

(h) ". . . the actual control of income and the purpose for which it is used . . .":

The father completely controlled the income, and no part of it was ever distributed to the children.

(i) ". . . and any other facts throwing light on their true intent . . .":

There was no change in the children's circumstances. Both continued to work for wages or salaries commensurate with the work performed by them. The fact that Margaret, in later years, was given some stock of doubtful worth and two pieces of real property (at least one of which was encumbered by mortgage) by her father in no way indicates the *bona fide* existence of a partnership, but, rather, the father's continuing desire to make some provision for his daughter.

In its decision the Tax Court leans heavily upon the case of *Maletis v. United States* (9 C. A.), 200 F. 2d 97, and the cases therein cited, holding in effect that, when a taxpayer has created a form of business for tax purposes, and in fact such form is a sham or fictional, it is only the Commissioner who has the power to sustain or disregard the fiction.

While it is true that the appellants signed the original partnership agreement, the amendment thereto, individual income tax returns, and documents authorizing additional assessment of taxes for 1945 based on revised earnings of Sherry Enterprises, and it is true that each stated under oath to Government agents investigating their father that he or she was a partner at the time of the statement, these facts, standing alone, omit the very essence of this case, to wit, that neither the father nor the appellants intended to join together in the present conduct of the enterprise. The appellants' only desire was to please their father and to obey his orders and instructions. They did not expect to receive, nor did they receive, income or property as a result of the arrangement set up by their father; nor were they intentionally and reasoningly parties to the arrangement. They were not free agents, acting under their own volition, but were, rather, under the dominion and control of their father. They did not elect to act as partners.

The father's intentions are also clear. He did not intend a present partnership but, rather, that he would continue to receive and enjoy all of the income and dispose of the assets as he saw fit, tempered by a measure of protection for his children in the event of his death. The arrangement also served to divest his wife (stepmother of appellants) of one-half of her community interest in the assets involved.

It is undoubtedly true that the position of Nathan Sherry, if he were taxed with the entire income by the Commissioner, or, on the contrary, if he were frustrated by the Commissioner in attempting to disregard the partnership, would be indefensible under the holding of this Court in *United States v. Maletis, supra.* The children,

however, not being the moving parties in establishing the business form, are not so inhibited.

Attention should be directed to the case of *Sellers v. Commissioner* (9 C. A., 1955), 218 F. 2d 380, wherein this Court entertained an appeal from a decision of the Tax Court that the family partnership there involved lacked good faith and a business purpose and therefore did not constitute a partnership for the purposes of taxation. In that case neither of the two children, a son and a daughter, contributed particular services to the partnership. Both, in fact, were away during a large portion of the period involved, the son being in the armed service and the daughter married to an Air Force officer, and neither contributed any services to the management of the partnership. Their capital contribution had consisted of promissory notes, which were subsequently paid from the profits of the enterprise. The partnership was under the management of the father, who utilized the funds as he saw fit and paid only small amounts to the children. The father also paid the taxes on the children's purported share of the partnership earnings. This Court stated, at page 383:

> "There was no evidence that the children ever instructed their father or the responsible employee in the family partnership to invest their money as it was invested or in any other way. From all these circumstances the tax court could have inferred that the father controlled the distribution of funds to the children and use of those funds.
>
> "From a consideration of all these factors it is apparent that the tax court was justified in concluding that the children were not bona fide members of this family partnership and that it was not attempted to be formed in good faith and for a business purpose. *To have decided otherwise would have been to violate*

the first principle of income taxation: that income must be taxed to him who earns it. Commissioner of Internal Revenue v. Culbertson, supra; Lucas v. Earl, 281 U. S. 111, 50 S. Ct. 241, 74 L. Ed. 731." (Emphasis added.)

It is the contention of these appellants that, in the instant case, from the evidence before it, the Tax Court should have concluded that the children were not *bona fide* members of the family partnership and that "it was not attempted to be formed in good faith and for a business purpose," and that the Tax Court's decision to the contrary was violative of the principle that income must be taxed to him who earns it.

The effect of the Tax Court's decision, if permitted to stand, is to throw upon these two young persons tax deficiencies of approximately $75,000.00 each, including accrued interest, with presently accruing interest in excess of $3,000.00 per year. A lifetime of savings, in their current positions, would not meet these liabilities; indeed, it is doubtful if either could meet the annual interest requirement. This result would, indeed, be the visitation upon the children of the sins of their father.

Conclusion.

It is respectfully submitted that the decisions appealed from should be reversed.

Charles H. Carr,

Attorney for Appellants.